SECTOR WATCH

Value's time to shine

Inflation and the economic recovery will support portfolio managers looking for deals

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AFTER A DECADE-PLUS PERiod of outperformance by growth stocks, value stocks are poised to benefit from improving economic conditions.

Late last year, value stocks began outperforming growth stocks as vaccine approvals and the prospect of increased stimulus in a Democrat-led Washington led to a rotation based on optimism about a global economic recovery. Over the past year, the Russell 1000 Value index has outperformed the Russell 1000 Growth index.

Several drivers are set to continue supporting a value cycle, including healthy consumer and corporate balance sheets and a resilient banking system. Fiscal spending will also play a big part in this cycle and should support economic and wage growth.

Value investing also will benefit from rising inflation and the potential for higher interest rates.

"Moderately rising inflation is constructive for value strategies," said Richard Wong, senior vice-president, portfolio manager and head of the Mackenzie Cundill team with Toronto-based **Mackenzie Investments**. "If rising inflation is due to good economic growth and leading to higher interest rates, it's very good for value strategies and quite negative for growth strategies."

Wong, portfolio manager of the $1-billion Mackenzie Cundill Value Fund, said he anticipates the value rotation will accelerate if inflation stays above 2%.

Furthermore, "earnings over the next year could trigger the shift away from growth stocks because we believe the pandemic pulled forward a lot of revenue and profit growth for technology companies into 2020 and early 2021," he said. "The current multiples on growth stocks don't account for this potential future weakness."

As of July 31, the Mackenzie fund had a one-year return of 22.6%, while the Morningstar Global Markets GR CAD index was up by 25.3% over the same period.

The Mackenzie fund uses a bottom-up strategy to invest in global equities and usually holds about 60 securities. The fund invests in three types of value stocks: deep value stocks, which are significantly out of favour and very cheap; cyclical value stocks, which lead their respective sectors but are cheaply valued and near the trough of their industry cycles; and quality value stocks, which have recurring revenue and can compound their earnings over time.

"During the initial and middle phases of an economic cycle — where we think we are now — we would have more exposure to deep value and cyclical value," Wong said. "As the economic cycle slows and the risk of a recession emerges, we would move more exposure to quality value stocks, which are more resilient."

The Mackenzie fund is currently overweighted in cyclical sectors such as financials, consumer discretionary, energy and materials. "We see many businesses yet to fully capture the improved economic and demand environment in their valuations," Wong said.

Meanwhile, the Mackenzie fund is underweighted in consumer staples and health care. "These sectors could face less upside in a strong economy," Wong said. The fund also is underweighted in technology "as it's more difficult to find out-of-favour and low-valuation stocks in that sector," he said.

One of the fund's largest holdings is Montreal-based SNC Lavalin Group Inc., a fully integrated professional services and project-management company. "Under the leadership of a new management team, SNC is transitioning to a pure-play engineering services firm, where it will have better visibility and less volatile earnings — which should re-rate the stock meaningfully higher," Wong said. "We believe that on a sum-of-the-parts basis, SNC is significantly undervalued relative to peers."

Another major holding is General Motors Co., the multinational auto manufacturer and distributor. Wong said GM is one of the few manufacturers that can make EVs "that consumers want to buy and at scale, given the significant [research and development] investments required to succeed."

Within the past six months, Wong also bought shares in California-based Skechers USA Inc., the world's third-largest footwear brand. "The brand is positioned to deliver quality and style at mass price points," he said, and is "investing heavily in direct-to-consumer and e-commerce."

IN RECENT YEARS, "THE valuation discrepancy between growth and value stocks became so large that people started to take notice," said Don Simpson, vice-president and portfolio manager with Dynamic Funds, a division of Toronto-based **1832 Asset Management LP.** "The bigger the discrepancy, the better for value stocks."

Simpson, who manages the $1.3-billion Dynamic Value Fund of Canada, said conditions favoured a rebound in value stocks once the economy began to improve and interest rates began rising. Like Wong, Simpson believes "a little bit of inflation" is good for value stocks in sectors that benefit from higher prices, such as commodities, consumer staples and financial services.

As of July 31, the Dynamic fund had a one-year return of 28.7%, while the Morningstar Canada GR Canada index was up by 29.0% over the same period.

The Dynamic fund invests in a diversified mix of businesses that have the ability to grow and generate good cash flows. The companies should have strong balance sheets and management teams that "we know and trust," Simpson said. The portfolio is diversified by industry and ideas, and comprises 30 to 40 names.

Simpson said he determines which businesses are undervalued by meeting with management teams in order "to find out what makes the businesses tick."

Simpson uses a bottom-up investment strategy to select stocks, but pays attention to how his ideas will play out in macro conditions. "What will happen if something goes wrong?" he asks himself.

The Dynamic fund's heaviest weighting is in financials, with one-third of that in alternative asset managers such as Power Corp. of Canada and Onex Corp. Such companies are extremely undervalued in the current environment, Simpson said.

Power Corp., a major holding in the Dynamic fund, is trading at a 30% discount to its net asset value. Simpson said the firm has taken steps "to collapse its complicated holding structure," and that its subsidiaries continue to experience strong growth under good management. Onex Corp., meanwhile, is trading at a 25%–30% discount, he said.

Within the past six months, Simpson bought shares in Fairfax Financial Holdings Ltd., a company with interests in insurance and investment management. Simpson said the company has a solid balance sheet, good execution capabilities and the potential for healthy growth. Further, its insurance business will benefit from higher prices.

Simpson also bought shares in Winnipeg-based Winpak Ltd., a leading manufacturer of plastic packaging for the food industry. The company is a "Steady Eddy business with a reliable stream of free cash flow," he said. Winpak also has a large amount of net cash on its balance sheet and "a lot of room to grow."

The energy sector comprises 9% of the Dynamic fund's holdings and the fund "has been rotating back into pipelines, which have good free cash flows," Simpson said. "The valuation discount is so wide that you are getting paid for the risk."

As of July 30, the fund has a 5% weighting in communication services, 8.5% in industrials and 6% in health care.

Within the past six months, Simpson sold the fund's holding in Minn.-based Ecolab Inc., a water purification company, because "its multiple got too stretched." He also sold Apple Inc. because of its high valuation. Apple is a quality company, Simpson said, but he "found better ideas" in Canada. IE